ISSUE DATE: March 1, 1999

DOCKET NO. E-017/PA-98-1345

ORDER DETERMINING ACCOUNTING

BEFORE THE MINNESOTA PUBLIC UTILITIES COMMISSION

Edward A. Garvey	Chair
Joel Jacobs	Commissioner
Marshall Johnson	Commissioner
LeRoy Koppendrayer	Commissioner
Gregory Scott	Commissioner

In the Matter of Otter Tail Power Company's Petition for Approval of the Transfer of Property to the City of Wahpeton

ISSUE DATE: March 1, 1999

DOCKET NO. E-017/PA-98-1345

ORDER DETERMINING ACCOUNTING

PROCEDURAL HISTORY

On September 18, 1998, Otter Tail Power Company (Otter Tail or the Company) filed a request for permission to sell the building housing its eastern North Dakota and western Minnesota headquarters to the City of Wahpeton, North Dakota. The petition challenged the Commission's jurisdiction over the transaction and requested a finding of no jurisdiction. In the alternative, the petition requested approval of the transaction and approval of the proposed accounting treatment, which would attribute the gain on the sale to the Company's shareholders.

On December 14, 1998, the Commission issued its ORDER FINDING JURISDICTION AND APPROVING PROPERTY TRANSFER. In that Order, the Commission found that it has jurisdiction over the property transfer pursuant to Minn. Stat. § 216B.50. The Commission found that the sale was consistent with the public interest and approved it. Finally, the Commission separated and deferred for later hearing the issue of accounting for the gain on sale.

On December 8, 1998, the Department of Public Service (the Department) filed comments on the appropriate accounting for the gain on sale. The Department recommended that the Commission require the Company to credit ratepayers with the gain on sale by recording the sum in Account 108, Accumulated Provision for Depreciation of Electric Utility Plant (the Depreciation Reserve).

On December 31, 1998, Otter Tail filed reply comments objecting to the Department's recommendation. Otter Tail proposed attributing the gain on sale to shareholders by recording the gain in Account 421.1, Gain on Disposition of Property.

On February 4, 1999, the issue of accounting for the gain on sale of the Wahpeton property came before the Commission for consideration.

FINDINGS AND CONCLUSIONS

I. FACTUAL BACKGROUND

Otter Tail provides electric service in the states of Minnesota, North Dakota, and South Dakota. Wahpeton, North Dakota serves as the Company's division headquarters for Otter Tail's service area in eastern North Dakota and western Minnesota.

In 1991, Otter Tail completed construction of its Wahpeton Division Office at a construction cost of $961,781.97.[1] Otter Tail built the office to accommodate office and administrative functions, and service, repair, and metering personnel. Otter Tail also used the building as a garage for utility service trucks, vans, and related equipment.

Since construction of the Wahpeton building, Otter Tail has depreciated the building and related property, resulting in a net book value of $796,128.76 as of September 9, 1998.

As a result of Company changes, including the sale of its high voltage testing laboratory formerly housed in the Wahpeton central warehouse, Otter Tail decided to move the Division Office personnel and operations to the Wahpeton central warehouse and to sell the Wahpeton Division Office building. Otter Tail estimated costs of approximately $225,000 to remodel the existing Wahpeton warehouse to accommodate the Division Office functions and personnel.

Because Otter Tail would no longer need the Wahpeton Division Office building, the Company agreed to sell the property to the City of Wahpeton for a new city hall at a price of $1,175,000. The sale/purchase was approved by the Commission in its December 14, 1998 Order. Otter Tail realized a gain of approximately $385,000 over the net book value as a result of this transfer.

II. POSITIONS OF THE PARTIES

A. The Department

The Department argued that the Federal Energy Regulatory Commission's Uniform System of Accounts (FERC's USOA), which the Commission has adopted, allows the Commission to require Otter Tail to record the gain on sale of the Wahpeton property either in Account 108, the Depreciation Reserve, or in Account 421.1, Gain on Disposition of Property. The Department cited a number of decisions by federal courts and the FERC, in which the gains on sale of utility property were not wholly credited to shareholders. The Department also cited two Commission decisions, in which the Commission allowed the gain on sale of utility property to flow to ratepayers. <u>In the Matter of the Petition of Minnesota Power to Sell a Twenty Percent Ownership Share in the Boswell Generating Unit No. 4 Facilities to the Wisconsin Public Power Incorporated System</u>, Docket No. E-015/PA-90-153, ORDER APPROVING BOSWELL SALE (August 24, 1990); <u>In the Matter of the Application of Otter Tail Power Company, a Minnesota Corporation, for Authority to Sell Certain Electric Facilities to Western Minnesota Municipal Power Agency</u>,

[1] This sum includes the cost of the building, furniture and fixtures, and certain communications tower and equipment.

Docket No. E-017/PA-88-913 (December 16, 1988).

The Department argued that the courts have traditionally applied two principles to determine the allocation of a gain on sale of utility property: gains in the value of utility property should be allocated to the party or parties who bore the risk of capital loss with respect to that property; and the party who bore the burden of the property should reap the benefits that flow from its sale. According to the Department, analysis under both criteria supports attributing the gain to ratepayers. The Department argued that ratepayers have borne the burden of the property through their payments for return on investment, depreciation, operating and maintenance expenses, tax and insurance costs, and the further cost in this case of remodeling a substitute facility. According to the Department, shareholders have not borne the risk of loss in this case because Otter Tail has stated that--absent some financial incentive--it would not sell property at a loss since ratepayers would continue absorbing costs associated with the property.

The Department argued that allocation of the gain into Account 108, as it has recommended, in effect distributes the gain between ratepayers and shareholders. Shareholders receive the funds from the sale in the year in which it occurs, but the gain flows to ratepayers through a reduction in future depreciation expenses. The utility's share of the gain, therefore, is the time value of the funds over the remaining lives of the facilities remaining in service.

B. Otter Tail

Otter Tail agreed with the Department that the Commission has the discretion to require allocation of the gain in a manner different from the usual USOA allocation to shareholders under Account 421.1. Otter Tail argued, however, that extraordinary or unusual facts do not exist in this case to warrant such an exception. Ratepayers have merely borne the usual carrying charges associated with utility property--depreciation, taxes and insurance, and other associated operating and maintenance expenses. If payment of these ordinary charges supported an exception to allocation in Account 421.1, the presumption of such an allocation would be rendered hollow.

Otter Tail argued that the USOA ordinarily assigns the risk of loss of "plant as an operating unit or system" to shareholders, and rightfully also assigns any gain to those investors. If the Commission departs from usual policy and requires a sharing of the gain between ratepayers and shareholders, the Commission should also shift a portion of the risk of loss to ratepayers. Absent willingness to assign some of the risk of loss to ratepayers, the Commission should not depart from usual USOA policy and require shareholders to share the gain on sale with ratepayers.

Otter Tail argued that ratepayers are being treated fairly with the usual allocation of gain to investors. If allowed the usual accounting treatment, Otter Tail would be reducing rate base by approximately $571,000 (the net book value offset by the remodeling costs of the substitute facilities) and reducing annual Minnesota revenue requirement by approximately $60,000.

Finally, Otter Tail argued that the cases cited by the Department to justify allocation of gain to ratepayers were inapposite. Otter Tail noted that the two cited Commission decisions both involved a utility's voluntary recording of the gain to ratepayers in a manner contrary to usual practice under the USOA.

III. COMMISSION ACTION

The Commission has adopted the FERC Uniform System of Accounts for utility accounting. Instructions for that system indicate that gain on sale of electric plant shall be included in Account 421.1, Gain on Disposition of Property, "[u]nless otherwise ordered by the Commission..."[2] 18 C.F.R. Ch. 1 (4-1-98 Edition), Pt. 101, § 5F. The parties agree, and the Commission affirms, that the Commission therefore has the discretion to require the gain on sale in this case to be allocated either to Account 421.1 (thus to the benefit of shareholders) or to Account 108 (thus to the benefit of ratepayers).[3]

Because the accounting treatment of amounts realized (or lost) on the sale of utility property is subject to the Commission's discretion, the Commission must answer questions raised on such allocation issues on a case by case basis.

In this set of facts, Otter Tail constructed a building in 1991, at a cost of approximately $962,000, to accommodate division headquarters business. Following normal utility accounting practice, Otter Tail depreciated the building until September, 1998, at which time the building held a net book value of $796,000. During the seven years Otter Tail owned the building, the depreciation, maintenance, operations, and returns on the investment in the building were provided for in rates. When Otter Tail sold the building in 1998, the Company realized a net gain of approximately $385,000 (net book value subtracted from net sale price).

The Commission has the discretion to require Otter Tail to attribute its gain on sale for the benefit of shareholders (through Account 421.1) or ratepayers (through Account 108). If Otter Tail were allowed to credit the gain on sale to Account 421.1, the Company would have received back all of its investment (through depreciation and the cash on sale) plus the $385,000 in gain on sale. Otter Tail would also be allowed to depreciate its $225,000 investment in the retrofitted warehouse (which will replace the sold building). If Otter Tail were required to credit the gain on sale to Account 108, the Company would have received back all of its investment (through depreciation and the cash on sale) but would credit the $385,000 gain on sale to the Depreciation Reserve, where it would, over the life of the remaining property, reduce depreciation expenses recovered in rates. Otter Tail would also begin depreciating the $225,000 capital expense of

---

[2] Although the FERC rules are referring to the FERC as "the Commission," the instructions are applicable to the Public Utilities Commission since it has adopted the FERC system of accounting.

[3] Under either accounting treatment, the Commission retains the authority to examine the prudence and reasonableness of this investment in a future rate case.

retrofitting the warehouse.

Under either scenario, investors would have received a return on and a return of their capital investment in utility property. Under the former scenario, however, investors would have received a return of their capital investment plus a large portion of the salvage value of the property at its retirement. The former scenario--shareholders' receipt of the $385,000 gain on sale through the attribution of the gain to Account 421.1--goes beyond the statutorily-expressed goal of establishing rates that will provide shareholders a fair return on investment and a return of capital investment:

> The Commission, in the exercise of its powers under this chapter to determine just and reasonable rates for public utilities, shall give due consideration to the public need for adequate, efficient, and reasonable service and to *the need of the public utility for revenue sufficient to enable it to meet the cost of furnishing the service, including adequate provision for depreciation of its utility property used and useful in rendering service to the public, and to earn a fair and reasonable return upon the investment in such property*. (Emphasis added).
>
> Minn. Stat. § 216B.16, subd. 6.
>
> "Depreciation accounting" means a system of accounting which aims to distribute cost or other basic value of tangible capital assets, *less salvage*, if any, over the estimated useful life of the unit, which may be a group of assets, in a systematic and rational manner. (Emphasis added).
>
> Minn. Rules, part 7825.0500.

Attribution of this gain to ratepayers through Account 108 is therefore more consistent with the statutory goals of ratemaking.

Attribution to the benefit of ratepayers is also consistent with the distribution of burden/risk of loss. In this instance, ratepayers have borne all the ordinary burdens of taxes and insurance, operations and maintenance, depreciation and return on investment during the time the property was in use by the utility. Ratepayers may be considered also to have borne the risk of loss--in the form of potential utility recovery of out-of-the-ordinary expenses associated with utility property. In rate cases, utilities have the opportunity to prove that they should recover certain expenses/losses relating to property because the expense was prudently incurred and the property was used and useful in the provision of utility service during its lifetime. In such cases, ratepayers may be required to cover the expenses in rates. *See*, for example, In the Matter of the Request of Interstate Power Company for Authority to Change Its Rates for Gas Services in Minnesota, Docket No. G-001/GR-95-406, FINDINGS OF FACT, CONCLUSIONS OF LAW, AND ORDER (February 29, 1996), in which the Commission allowed Interstate to recover all of its manufactured gas plant cleanup costs because the costs were prudently incurred and the sites were used and useful for the provision of utility service. *See, also*, In the Matter of the

Application of Northern States Power Company for Authority to Increase Its Rates for Electric Service in the State of Minnesota, Docket No. E-002/GR-91-1, FINDINGS OF FACT, CONCLUSIONS OF LAW AND ORDER (November 27, 1991), in which the Commission disallowed NSP's request to recover expenses of decommissioning the Pathfinder nuclear facility because the facility was only in full operation for one hour and thus had not been used and useful for utility service, and because NSP had not undertaken or pursued the ill-fated nuclear project in a prudent fashion. Thus, in a case by case ratemaking analysis, ratepayers may bear the risk of loss on utility property if they are required to cover out-of-the-ordinary expenses associated with the property.

Ratepayers may also be considered to have borne the risk of loss on utility property because risk of loss is one element by which rate of return is calculated in rate cases. In a 1987 Otter Tail rate case proceeding, the Commission excluded the Company's abandoned Spiritwood cogeneration project from rate base because the property had not been used and useful. The Commission found that the Company had not been unfairly exposed to uncompensated loss upon abandonment of the property because the Company had been compensated for the risk of loss through the rate of return allowed. The Commission stated that "[t]he investment risk has been taken into account and included in the rate of return." In the Matter of the Petition of Otter Tail Power Company for Authority to Increase Rates for Electric Service in Minnesota, Docket No. E-017/GR-86-380, FINDINGS OF FACT, CONCLUSIONS OF LAW, AND ORDER (April 27, 1987), at p. 8.

In this case, therefore, the Commission finds that Otter Tail's attribution of the gain on sale of the Wahpeton building to Account 108 would be consistent with the goals of regulatory rate-setting, in line with traditional regulatory analysis, and consistent with Commission decisions in the cases cited by the Department. Accounting for the funds in this manner accords Otter Tail the return of capital investment anticipated by statute, no more and no less. Furthermore, placement of the sum in the Depreciation Reserve will allow Otter Tail the time value associated with the funds through future depreciation calculations. The Commission will require Otter Tail to record the gain on sale of the Wahpeton property to Account 108, the Depreciation Reserve.

ORDER

1. The Commission requires Otter Tail to record the gain on sale of the Wahpeton property in Account 108.

2. This Order shall become effective immediately.

BY ORDER OF THE COMMISSION

Burl W. Haar
Executive Secretary

(S E A L)

This document can be made available in alternative formats (i.e., large print or audio tape) by calling (651) 297-4596 (voice), (651) 297-1200 (TTY), or 1-800-627-3529 (TTY relay service).